Secular stagnation as a result of economic maturity or deepening underdevelopment?

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Abstract

In this article, we critique the secular stagnation hypothesis and offer an alternative theoretical framework capable of more fully explaining the current economic trajectory of developing countries: falling interest rates, asset price deflation, and falling investment.

JEL Codes

B26, D31, E44

Introduction

In recent years, the secular stagnation hypothesis (SSH) has become one of the more prominent explanations for the poor economic performance of developed countries. Larry Summers has been one the theory's most prominent advocates, and in his short 2020 article "Accepting the reality of Secular Stagnation", states that "I am not aware of any other theory that can explain sluggish growth in the face of hyper expansionary policies and rapid acceleration in private sector credit growth (Summers, 2020:19). In this paper, we offer a different theory to explain the phenomena analyzed by the secular stagnation hypothesis, including low interests rates, and a slowdown in production, investment, and employment.

As we argue, these results are products of the global evolution of financialization, and can be fully explained under the theory of underdevelopment as put forth by Latin American structuralism. As opposed to the SSH, that gives primacy to monetary forces, structuralism gives first importance to social forces, and special emphasis to inequality as the principal symptom and cause of underdevelopment, manifest in the shallowing of national markets, productive dualism/ structural heterogeneity, and the external constraint,

among others. Here we only mention inequality and dualism in any detail. In the case of the United States (US), the growing polarization of the interests of financial rent and the living conditions of the growing precariat class have become ever more manifest in society at large, and reflected in economic data by the long term decline of productive credit, productive investment, and the wage share in national production. In this short article, we argue that the structuralist framework offers a more complete guide to underdevelopment, and offers a much more complex diagnosis to the challenges currently facing the US and other developing countries than the current mainstream framing of the problem.

A critical view of the SSH

Summers often gives credit to the SSH to Alvin Hansen in the 1950s. Summers also states that SSH can be observed prior to the Great Financial Crisis (GFC) (2020: 4). On their own, both statements are true. However, the SSH was not being discussed in the bubble driven economies of of the 1990s or 2000s. It was only after the GFC that the crisis rose to prominence. In 2013, Summers gave an influential speech on the SSH, which Krugman reported on: 'Summers's answer is that we may be an economy that needs bubbles just to achieve something near full employment – that in the absence of bubbles the economy has a negative natural rate of interest' (Krugman, 2013). The admission that, in retrospect, financial bubbles were propping up the economy is important, particularly for what it advises for the future: 'when looking forward you have to regard the liquidity trap not as an exceptional state of affairs but as the new normal' (Krugman, 2013).

In more recent years, the SSH has given less emphasis to the the permanent liquidity trap and more to other factors such as demographic change, and recently, and the idea that 'mature industrial economies are prone to secular stagnation' (Lukasz and Summers, 2019). To begin to offer a different explanation, we would slightly change Summers's statement: it is not economic maturity per se, but rather the maturation of financialization that leads to secular stagnation. With this change, we can fully agree that secular stagnation was present well before the GFC, and that underlying asset price deflation was only temporarily masked by bubbles. And while financialization had been maturing with ever fewer no new markets to open up, the GFC did indeed mark a very important inflection point, as it evaporated trust within the credit system, guaranteeing a fuller separation between finance and

production, as well as the absence of both credit-driven bubbles and productive credit expansion.

Lucasz and Summers do not deny the inflection point, but do not widen the range of diagnosis when the overwhelming evidence points to the limits of the only tool recommended for the job. The SSH, while perhaps nominally Keynesian in theory, is in fact a clear manifestation of the dominance of monetarist theory, under the firm conviction that the stabilization of the economy is the result of the application of monetary policy. In his criticism of Keynesian thinking, Friedman states that 'the 'monetarists' rejected this proposition and maintained that fiscal policy by itself is largely ineffective, and that what matters is what happens to the quantity of money' (Friedman, 1970: 8). For years, defenders of the privileged use of monetary policy have argued that changes in economic conditions define the action of central banks: "… virtually every contemporary discussion of stabilization policy by economists — whether it is abstract or concrete, theoretical or practical — is about monetary policy, not fiscal policy" (Blinder, 2004: 1). Therefore, any stabilization policies must consider monetary policy and thus the determination of the interest rate as the key data. Blinder concludes: "Under normal circumstances, monetary policy is a far better candidate for the stabilization job than fiscal policy. It should therefore take first chair" (Blinder, 2004: 39).

Based on these ideas, a reduction in the benchmark interest rate has been implemented at various times in recent decades, and asset purchase programs of central banks increased and widened through programs of quantitative easing, yet developed economies have not been able to escape from extremely low to negative interest rates. Monetary policy has become similar across the board: increase liquidity in the banking system, lower interest rates on longer-term assets, and thereby increase bank loans. Yet the results have not been those predicted by theory, particularly that companies would demand loans with falling interest rates.

But also that with the reduction of interest rates and the increased liquidity of the banks, market rules would operate according to monetarist theory, and finance would be restored, with the proper allocation of resources advancing investment and growth. In Friedman's language, central banks would have used their ability to alter the quantity of

high-powered money through open market operations, thereby establishing the conditions for stabilization (Friedman and Schwartz, 1963; Friedman, 1970).

As suggested by Krugman, secular stagnation could be seen as a type of permanent liquidity trap. However, the global structures of financialization allow ample room to argue that neither fiscal nor monetary spending can shunt economic trajectories towards investment production and employment. As JKG argues, "money must be not only manufactured but spent - made to operate directly on the state of trade" (Galbraith, 1975: 215). As has been argued elsewhere, financialization has fundamentally deformed the processes through which monetary creation leads to productive investment and therefore production and employment. Investment is a key point of divergence, with investments in the real sector languishing, while ever greater financial resources are channeled to financial markets (Vidal and Marshall, 2017).

Investment and monetary policy

Productive investment growth has followed a decades long patter of weakness in developed countries; the average growth data of the Gross Fixed Capital Formation (GFCF) in the first decade of the current century is lower than in the 1990s, and in the past decade there has been no change in this trend. This growing weakness is associated with the behavior of the economy as a whole (Vidal, 2021), and GFCF results during the pandemic should be taken within this context.

This is also the context within the defenders of the secular stagnation hypothesis insist upon its defense, considering it the best explanation of the situation. The explanation revolves around monetary conditions, insisting upon the abundance of savings with a decrease in investment demand. There are two fundamental problems with such an explanation: the first is more theoretical, while the second is more related to changing economic structures.

As Vernengo (2020) summarizes: “Summers's argument is that the natural rate of interest, a concept that had been somewhat neglected by central bankers after the Keynesian revolution, persistently declined, in part because of a contraction in the rate of interest, the

investment curve and, in part, by an increase in the savings curve, in a traditional argument of the Loanable Funds Theory". In *The General Theory*, Keynes makes a critically examines what he calls the classical theory of the interest rate. In its development within the neoclassical school leads to the conclusion that there is a "natural", "neutral" or "equilibrium" rate of interest, an idea that Keynes totally refutes (Keynes, 1936: 183). The recovery of the concept of the natural rate of interest is the intellectual offspring of the monetarism of Friedman.

The second problem with the SSH is that it does not take into account the relevant changes in economic structures in its explanation of the imbalance in the savings-investment ratio, in which the abundance of savings is met with a decrease in investment (Summers, 2014 and 2020). Less relevant changes are considered, such as the reduction in the prices of capital goods, which reduces investment demand (Eichengreen, 2015). We argue that a different framework, with different facts highlighted, allows for a more correct diagnoses.

There is certainly a grave imbalance between savings and investment at the core of the productive system. However, we argue that this is first, the result of the financialization of the banking sector, and the transition from credit based productive lending to asset based financial speculation; and second, the breakdown in productive investment in the wake of the GFC. This framework easily accommodates weak economic growth, in which a downward trend in GFGC leads to serious problems in reaching inflation targets. The lack of productive investment also explains the secular stagnation in labor's wages, participation, and share of national production.

The structural and institutional transformations that have resulted from decades of public policies that promote financial globalization (Correa, 1998), in conjunction with transformations in the management of large corporations (Vidal, 2019). These considerations are absent from the SSH, but are the most relevant facts for the financialization viewpoint, at the heart of the weakness growth of the economy and investment. Relatively soon into the resurgence of the SSH, mainstream analysis was questioning any positive relationship between lower interest rates and increased investment. A study by Sharpe & Suarez (2014) reached concludes that companies are quite insensitive

to interest rate reductions, highlighting that investment behavior is less sensitive to interest rate behavior in companies that expect higher income growth. Shortly before the pandemic, mainstream analysis had also accepted the reality of extremely low interest rates maintaining "zombie" corporations (Banerjee and Hoffman, 2018).

At the current juncture of mature financialization, the credit system does little to create investment and support production and employment, and more to channel resources to the now dominant asset backed financial sector. Over the last twenty to thirty years, monetary policy has been able to re-established the profitability of the financial markets. In both the wake of the GFC and during the pandemic, the performance of systemically important financial institutions, as well as the behavior of the stock market indicators, has reflected the design of policy action. However, the forces of deflation have not relented.

Under an underdevelopment framework, the financialization of the firm (productive and financial) has led to Temin's (2016) conception of dualism. In Latin America, the term dualism was popularized by Arthur lewis, and subsequently criticized by Celso Furtado and others. As Latin American countries are in general defined by multiple modes of production residing within one national territory, the term structural heterodoxy gained currency. In the US and other developed countries, single productive systems covers the great majority of territory and populations. When speaking to the US, dualism is a more apt term, but also speaks to the different history of the regions. In the case of developing countries, financialization has transformed the modern sectors of agriculture, industry and service, but has not united them in much, other than rent extraction. In the case of developed countries, financialization has polarized societies to the degree that we can now consider two separate regimes of accumulation in the US: that dependent on work and production, and that dependent on financial rent.

From a structuralist viewpoint, all types of monetary creation, be it fiscal, monetary, or private, will find their way into the financial system. This can explain the repeated processes of increases in the prices of financial assets amidst stagnation in productive investment and wages prior to the GFC. The huge wave of both fiscal and monetary spending during the pandemic has also channeled huge amounts to assets, whose prices continue to separate from underlying conditions in a historically novel form. The SSH

leaves aside many elements of analysis, and the application of the theory has failed to produce the desired results. However, its failings in developed economies are even more notable in developing economies particularly when speaking of economic maturity as a potential cause. No Latin American economy could be considered mature by the metrics of mainstream economics, however, we can argue that financialization is in its mature forms in LA, and for the same reasons as in developed countries. We could even go so far to suggest that some regimes of financialization have already reached full maturity in Latin America.

Conclusion

We have attempted to offer a theoretical framework with greater power to explain reality than the framework offered by the SSH. We have shown its deficiencies in terms of theory, public policy, and its applicability to developing countries that are also under neoliberal regimes. However, when taking into account non-market trends in the US, including institutional breakdown, the growing precariousness of work, the growing social problems of homelessness, violence and addiction, the limitations of the SSH become more evident.

Born as a refutation to neoclassical economics, Latin American structuralism parts from the positions that societies cannot be seen only through the lens of the market. The continual process of the underdevelopment of the US, as argued in Vidal and Marshall (2014), is perhaps best viewed from the sole academic school that sought to analyze just that, and hat established an academic framework able to account for all of its components. All processes of underdevelopment are different, and that of the US and other developed countries will follow historically novel routes. However, the framework offered by structuralism is not only applicable to a certain region in a certain time.

Today, developed countries, and the US in particular, is falling ever deeper into the dynamics of underdevelopment, again in its own form. Inequality is ever more visible, with the continued stabilization and profitability of financial markets in contrast to the living conditions of the common person. There is a growing fragmentation of markets, from the credit based and asset based ones at the top of the financial system, down to the

physical infrastructure of the country. Finance continues to decouple from production at the top, while at the level of the vast base, inequalities in public infrastructure, including health, education, and transportation, in addition to the diverging wage structures of the private market, are leading to the fragmentation of economic and social geography.

As we have argued, these elements have in their totality led to a decades long slowdown of investment, both public and private, that saw an important downward inflexion point after the GFC. While the proponents of the SSH continue to insist on finding the answer in monetary policy, if underdevelopment theory is used as a diagnostic tool, it demonstrates that the multiple problems that plague many developed countries - but the US in particular - will be little served by monetary policy alone.

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